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Protecting Minority Shareholders in Emerging Markets

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Minority shareholders are often viewed as an unnecessary burden, a 'dead weight,' by majority owners of corporations. This view is widespread in many transitioning economies, where capital markets are weak, minority investors are not commonly viewed as a source of capital, and incentives for long-term value-creation are distorted. It is also present in many developed markets.

However, minority shareholders can play an essential role in the governance and overall success of a company, as well as in the development and sustainability of capital markets. Their responsibilities, including oversight of board actions, create a check on the power of the majority shareholders and promote transparency, ethical practices, and good governance. In countries with weak institutions, their role in fostering good governance in companies and, as a result, moving economies forward, becomes so much more important.

More must be done to protect the rights of minority shareholders. Good corporate governance plays a major role in this. At the same time, more attention must be paid to voluntary associations and institutes and what they can do to protect shareholders rights. Such organizations are instrumental in creating awareness, exposing and combating abuses, and, overall, ensuring the implementation and enforcement of corporate governance standards.

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Minority shareholders are often viewed as an unnecessary burden, a 'dead weight,' by majority owners of corporations. This view is widespread in many transitioning economies, where capital markets are weak, minority investors are not commonly viewed as a source of capital, and incentives for long-term value-creation are distorted. In such economies, majority owners often feel that while having comparatively little at stake, minority shareholders can slow down or sidetrack crucial investment-related decisions, be inactive at times when the need for restructuring is pressing, or place unreasonable demands on management. In other words, minority shareholders, in the eyes of majority owners, tend to increase transactions costs.

While widespread in transitioning economies, such sentiments are present in all countries. Majority owners feel that they should have the right to make the majority of all decisions because they have more at stake. Evidence shows that extremely concentrated shareholder structures have actually benefited firms in developed countries from the standpoint of performance.[1] Does this, however, mean that firms in many emerging markets should not worry about weak investor protection and widespread highly concentrated ownership models?

The reality is that regardless of the fact that studies show that concentrated ownership structures can have a positive effect on firms' profits, one should avoid jumping to conclusions, as there are also costs associated with such a model. These costs are explored in more detail later in this article. However, regardless of costs and benefits, one should never declare a certain ownership model as the 'best practice,' as there are larger issues at stake.

A common mistake often made by some development experts throughout the 1990s, when a wave of privatizations swept through many emerging markets, was to advocate that companies adopt a certain model of ownership. In reality, however, both – dispersed and concentrated – models have a track record of successful performance as well as failure in a myriad of countries.

Taking this fact into account would lead one to conclude that the development of ownership structures should be looked upon as an evolutionary process – not as an transferable set of rules – that allows firms (as well as economies that those firms constitute) realize their goals of investment, wealth-generation, and sustainable growth. Ownership structures should be aligned with countries' market institutions, not transplanted across borders with the assumption that they will perform just as well in different economic, political, and social environments.

Take a closer look at privatization experiments, for example. In several former command economies, privatization advisors pushed for voucher-based processes, which provided the possibility of ownership to the majority of the population. In many cases, such strategies intended to cement the legitimacy of the privatization process by allowing the citizens to become property owners in the new market economy. However, the dispersed ownership voucher model failed in some cases because market structures were not in place to support such a process – investors' rights were not equally protected, stock markets were weak, corporate governance systems were not in place, the rule of law was lacking, etc.

In Russia, for example, voucher privatization resulted in employee-ownership structures, which led to more problems than benefits for companies. Among the consequences of insider ownership structures were the lack of incentives to restructure and the persistence of Soviet-style management, all of which resulted in the general inability of firms to attract investment and improve performance.[2]

Advocates of the Russian privatization model had originally hoped that employees would sell their shares and ownership structures would evolve according to the market process. However, numerous institutional barriers have prevented such a process from taking place. In the Czech Republic, on the other hand, voucher privatization worked quite differently. There, investment funds, which managed citizens' ownership in companies, became quite successful in directing investment towards more profitable companies.[3] A similar investment program failed in Russia.

In environments where the legal system fails to protect minority investors as well as specify their rights

and responsibilities, conflicts between majority and minority shareholders inject additional uncertainty into the business environment, increase risk, and drive away investment, both foreign and domestic. In economies where rules-based systems are not in place to resolve these conflicts, majority owners are more likely to resort to illegal measures to "squeeze out" minority shareholders.

Examples of such illegal techniques used to exclude minority shareholders from the decision-making process are abundant in developing countries. For example, in Russia in the 1990s, a simple way to prevent minority shareholders from "meddling in the affairs" of majority owners was to change the date and location of the general assembly meeting a day or two before the meeting would take place. Thus, minority owners would not get the information in time and could not adjust their schedules. Minority owners would show up at an empty meeting hall, while the actual meeting was held hundreds of miles away and decisions were made in their absence. Such blatant violations could be observed in Russia as late as 2001, when corporate governance practices were already being established, and are not uncommon in other countries today. Other techniques to reduce the power of minority owners and bar them from the decision-making process include changing registration procedures immediately prior to the meeting so that minority owners would not have the opportunity to vote, withholding financial information, and limiting minority shareholders' ability to hold the board accountable for violations.

In addition to illegal or semi-legal techniques, there are often legal measures used by majority owners to eliminate minority shareholders. "Squeeze out laws," as they are called, passed in Russia in 2004 and in the Czech Republic in 2005, allowed majority owners controlling 90% of the shares to buy out minority owners at a fair market price. Under these laws, majority shareholders were given the right to initiate the process to force minority owners to sell their shares. According to such "squeeze out laws," the only disagreement permitted is over the fairness of the price, but not over the actual right to sell.

While similar laws exist in developed economies, the differences lie in how the process works on the institutional level. In developed countries, where courts are more efficient and independent from political influence, there is much more transparency in how the actual "fair" market price of shares is determined. Also, in many developed economies where such laws are present, the threshold is higher than 90%, which means that firms expropriating minority shareholders already have an extremely high concentration of ownership.[4]

The arguments against minority shareholders exist in both developed and developing countries. However, there is one key difference that separates the two and makes the need for minority owners in developing countries much more pressing. In weak institutional environments, majority owners can easily engage in self-dealing and asset-stripping, thereby driving firms into bankruptcy and denying dividend payments to minority shareholders. The minority shareholders, in turn, have little control over such actions. Incentive structures in these environments are such that short-term profit extraction (or asset-stripping) replaces long-term value-creation strategies, and institutions are not strong enough to control this extraction. In other words, political and economic uncertainty leads to the attitude that "to steal today" is better than "to build for tomorrow" – and the system rewards that attitude by not punishing those that hold it.

Defining minority shareholders in institutionally weak environments is also much more difficult, as the division between minority and majority owners is much more vague. There is a good example of this from Russia, where in the 1990s, a Russian shareholder with 25% ownership could have more influence on management decisions and board composition than a foreign shareholder with 75% ownership. The reason for this is that, at the time, a Russian owner could gain access to enforcement mechanisms – legal and illegal – that were unavailable to a foreign owner.[5] While the days of "wild west capitalism" in Russia are arguably over, such examples still echo in Russia and other countries.

Further, although compelling arguments for and against minority shareholders exist on both sides, one cannot lose track of the key role they play in developed as well as developing economies. Massive asset-stripping during Russian privatization, the 1997

financial crisis in Asia, and the limited ability of family-owned firms in the Middle East and Latin America to attract investment have all underscored the importance of having minority shareholders as an oversight mechanism over legal infractions and an assurance tool for investors.

Choosing the Right Ownership Structure

Debates continue as to which ownership structures are best. One study of 376 enterprises in Ukraine found that concentrated ownership has been positively associated with firms' performance.[6] The same study also found that firms with concentrated ownership by foreign investors have outperformed those where ownership is concentrated by local owners.

Another study of Czech firms, however, found that dispersed ownership structures have a greater positive effect on sales than concentrated ownership structures.[7] There is also evidence from a study of 156 firms in eight new member states of the European Union (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia) showing that there is no positive relationship between performance and concentration of ownership.[8] Interestingly, the same study also showed that there are concrete benefits of foreign ownership for firm performance.

There are many other works in finance and economics that provide arguments for one ownership structure over the other. Before arriving at a final verdict, there is an issue that deserves more attention. It would be erroneous to compare developed and developing economies because ownership structures have often evolved over time in developed economies and concentrated ownership, therefore, is the outcome of the competitive market process.[9] In many developing countries, on the other hand, ownership structures have been imported or transplanted [along with the privatization processes, for example] and thus have a completely different impact on the market performance of firms. In developing economies, for example, laws protecting investors are often much weaker than in developed ones. Further, there are often deficiencies with the functioning of rule of law, where even if the laws protecting investors exist on paper, they may not be properly enforced. This is the issue that the earlier example of weak majority and strong minority owners in Russia illustrates well.

Therefore, the reason that companies with concentrated ownership sometimes outperform their competitors with dispersed ownership in developing countries may be that weak institutional structures limit the ability of firms with dispersed ownership to survive in environments where market and political players focus more on the present than the future. This may not necessarily mean that a more efficient firm performs better. A recent paper by the World Bank, for example, supports this point. The paper takes an in-depth look at a number of countries, and, using the Business Environment and Enterprise Performance Survey (BEEPS), determines that in countries with a weak business climate, efficient firms tend to fail while inefficient firms remain.[10]

Without proper protection of investors' rights, minority shareholders are vulnerable, while firms with concentrated ownership run the risk of assets being expropriated by majority owners. So, the question to be answered is not whether firms with concentrated ownership structures outperform those with dispersed ownership in developing countries, but rather: How can the market structures be reformed to allow for fair competition among firms and the natural evolution of ownership structures? Fairness, in this sense, does not mean equalizing firms' endowments or designating equal market shares. Rather, it means creating a system of rules, where some firms are not favored over others, all have equal access to political and market institutions, and rules are consistently enforced.[11]

The Role of Minority Shareholders

Minority shareholders have a role to play in emerging markets. They can be a "watchdog" over the board's actions and help to create effective and well-governed companies. They can be instrumental in the development and sustainability of capital markets as well. For example, expropriation of minority shareholders in Asia has been linked to the 1997 financial crisis.[12] In short, the expropriation of minority shareholders from corporations in the mid-1990s resulted in concentrated

ownership. As a consequence, conflicts of interest and a lack of transparency weakened corporations to the point where they found themselves at the center of the financial collapse.

As mentioned above, failed privatization across former command economies in Russia and some other Eastern European countries was partly due to a lack of protection of minority shareholders rights. Although people received vouchers that allowed them to become owners of privatized enterprises, the system functioned in such a way that those new minority owners had no voice in decision-making, which was done largely behind closed doors. As a result, many of the privatized enterprises plunged into a downward spiral of economic inefficiency and failure among countless asset-stripping schemes and misuse of corporate resources for personal gain. In some countries, privatization became synonymous with corruption, not ownership.

Simply put, in many emerging economies, a common consensus emerged over the past several decades that weak legal protection and the prevalence of relationship-based systems (where political access matters a great deal in economic decision-making) undermine the existence minority shareholders and, subsequently, their ability to fulfill their oversight role. However, this should not be used as an excuse, but rather as a motivation to put in place the measures that protect minority shareholders rights.

In all, minority shareholders can be a source of capital, they have the potential to drive transparency initiatives, promote ethics and good governance, and act as an assurance mechanism to other investors that there is no dominant insider-control in firms. This is essential in the absence of market mechanisms that provide such guarantees in developed countries.

In economies with weak corporate governance mechanisms and lacking rule of law, in cases of highly concentrated ownership and little protection for minority shareholders rights, investments (both foreign and domestic) are more likely to be misused. The lack of accountability and transparency mechanisms allows for discretionary decision-making on the part of majority owners, who may use the funds for their own personal benefit. In fact, a McKinsey study found that investors are willing to pay a premium as high as 40% for well-governed firms in emerging markets. The risk is clearly there, and so is the desire on the part of the investors to avoid that risk.

The problem of weak protection of minority shareholders' rights is becoming increasingly evident in the Middle East, where the majority of the firms are family-owned and corporate governance standards are often lax. As firms realize that to compete on the global scale they must tap into capital markets and attract foreign investment, they face the need to improve governance structures and develop mechanisms that ensure equal protection to all investors.

However, we also need to recognize the other side of the coin in many of the emerging markets. Minority shareholders can act as a burden on business if their rights and responsibilities are not clearly defined and if they themselves do not understand what they should and should not do. They can increase transactions costs if they are not aware of their responsibilities and if they make unreasonable demands. Thus, proper mechanisms can both protect minority shareholders and save majority owners from the 'tyranny of the minority.'

Protecting Minority Shareholders Rights: The Role of Associations

One answer to the minority shareholders rights problem is corporate governance. The implementation of corporate governance best practices can create transparent, responsible, and accountable businesses. In fact, corporate governance is not only about rules governing boards of directors or disclosure practices – significant attention is paid to minority shareholders. As the OECD's Corporate Governance Principles state, "Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress."[13]

However, while corporate governance mechanisms may put in place a set of rules, how does one ensure that shareholders have equal access to those rules?

How are those rules created in the first place? Do minority shareholders have a say in the process or are they presented with a set of rules with which they have to comply? How does one ensure that those rules are enforced? How can violations be exposed and grievances be redressed? What will facilitate communication between minority shareholders, so that they can identify common challenges and solutions?

Associations and institutes that focus on corporate governance problems provide some answers to these questions. Once the collective action problem is solved, minority shareholders will have the will and capacity to combine their resources to become an integral part of a country's capital markets. In this manner, majority owners will no longer be able to ignore the rights – and input – of minority shareholders. Through associations, minority shareholders can pool their resources together and work with the business community and policymakers to improve the legal and regulatory environment, and ultimately position countries as more investment-friendly destinations.

CIPE partner the Corporate Governance Center in Kenya is an illustrative example. It set out to conduct an awareness-building campaign on corporate governance rules to ensure that shareholders know their rights and to ensure that their rights are properly protected.

The Corporate Governance Center prepared and distributed guidelines (20,000 copies) on the rights of shareholders and their roles and responsibilities in the corporate governance framework, with emphasis on the rights of minority shareholders and how they can organize to promote good corporate governance. These guidelines constituted the first attempt to codify, translate into a local language, and widely disseminate detailed materials on the rights and obligations of shareholders.

The Corporate Governance Center also held a national convention to educate the public on the pillars and values that underpin good governance; the reasons why these principles are formulated and promulgated; the benefits that accrue from the implementation of those values, principles, and practices; and the role of the community in ensuring business' compliance with corporate governance best practices.

The Association for the Protection of Shareholders' Rights (Akcioner), a CIPE partner in Macedonia, has been instrumental in protecting the rights of minority shareholders in that country. In emerging markets, it is not enough to put the rules in place – much work remains to be done to ensure that the rules are properly enforced. Such work is very difficult, yet necessary when the rule of law is lacking.

Akcioner was created to educate small shareholders on their rights and responsibilities and to facilitate collective action in order to advocate for their interests. Upon joining the association, members recognized that they were not alone in their struggle for better shareholder protection. They came to believe that through united efforts, they could achieve substantive changes in the way companies are managed and operated in Macedonia.

Over the past several years, Akcioner has worked to build a more robust capital market environment in Macedonia through education of shareholders about the protection of their rights, free legal aid and counseling, representation and advocacy, mediation between companies and shareholders, and education of judges and lawyers.

Akcioner's activities to protect shareholders rights, promote investment, and help business to stand up for its rights have been quite successful. Over the past several years, Akcioner has established itself as a credible and reliable organization that can protect shareholders' rights and take legal action when needed. Increasingly, company managers respect the efficiency of Akcioner's legal department to persuade the courts to enforce the 2004 Company Law. The legal expertise of Akcioner and its growing public status act as a deterrent to violations of shareholder rights.

Conclusion

Reformers should be careful not to draw direct linkages between the performance of companies in

emerging markets and their performance in developed ones. The conditions under which companies operate can be quite different. This fact has a number of implications that should be taken into account when thinking about ownership structures and company performance. Most importantly, ownership structures should be viewed as a process, not as a rigid set of rules that can be carried over borders and put in place overnight. While there is value to international experience and a set of 'best practices,' these experiences must be combined with local realities to create companies that can meet today's challenges and join the global economy – while doing so in a manner consistent with ethical behavior and rule of law.

Protection of minority shareholders rights is an issue that lies at the core of this debate. In many emerging economies, minority shareholders are often dismissed as unnecessary, yet, they are instrumental in creating robust capital markets and sustainable companies focused on long-term value creation. Good corporate governance plays a major role in protecting the rights of minority shareholders and defining their responsibilities. At the same time, voluntary associations and institutes are also instrumental in protecting shareholders rights, creating awareness, exposing and combating abuses, and, overall, ensuring the implementation and enforcement of corporate governance standards.

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[13]See http://www.oecd.org for more information.

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